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IN THE

# United States Supreme Court

October Term, 1975

No. 75-970

C. JAMES MATHEWS AND JOYCE C. MATHEWS,

*Petitioners*

*v.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent*

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

THOMAS D. AITKEN
of
CARLTON, FIELDS, WARD, EMMANUEL,
SMITH & CUTLER, P.A.
P. O. Box 3239
Tampa, Florida 33601

*Counsel for Petitioner*

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C. JAMES MATHEWS AND JOYCE C. MATHEWS,

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COMMISSIONER OF INTERNAL REVENUE,

*Respondent*

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit entered on October 1, 1975.

## REFERENCE TO OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fifth Circuit, printed in Appendix A, is reported at 520 F.2d 323. The opinion of the United States Tax Court, printed in Appendix B, is reported at 61 T.C. 12.

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## GROUNDS ON WHICH JURISDICTION IS INVOKED

The judgment of the Court of Appeals, printed in Appendix C, was entered on August 16, 1974. The order denying Petitioners' motion for rehearing, printed in Appendix D, was entered on November 21, 1975. Jurisdiction to review the judgment of the Court of Appeals is conferred on this Court by 28 U.S.C. Section 1254(1).

## THE QUESTION PRESENTED FOR REVIEW

Where a taxpayer transfers the building used in his business to an independent trustee under ten year "Clifford" trusts for the benefit of the taxpayer's children, and, pursuant to a prior understanding with the trustee, leases the building back from the trustee for use in his business for a period of one year, renewable only upon mutual agreement of the parties, is the rent paid to the trustee deductible?

## STATUTE INVOLVED

The statute involved is Section 162(a)(3) of the Internal Revenue Code of 1954, 68A Stat. 45 (1954). It states:

"§162. Trade or business expenses

(a) In general.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred in carrying on any trade or business, including—

. . . .

"(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

## STATEMENT OF THE CASE

Petitioners, C. James Mathews (hereinafter referred to as "Mathews") and Joyce C. Mathews, his wife, resided in St. Petersburg, Florida, at the time they filed their petition in the Tax Court, on September 2, 1969, contesting determinations by the Respondent with regard to their joint federal income tax returns for the calendar years 1964, 1965 and 1966. The facts set forth below, as found by the Tax Court, are undisputed.

Mathews was a funeral director who operated Mathews Funeral Home in St. Petersburg, Florida. Prior to November 1, 1961, Petitioners jointly owned the real property on which Mathews Funeral Home was located. On November 1, 1961, Petitioners created separate irrevocable trusts for each of their four minor children and transferred to their attorney, Richard F. Logan (hereinafter referred to as "the trustee"), as trustee, by duly recorded warranty deed, four equal undivided interests in the funeral home property. Each trust provided that it would terminate ten years and one day after its execution, whereupon the trust principal would be distributed to the grantors or their estates. Each trust provided for current distribution of net income to the beneficiary. Mathews' wife was the court-appointed guardian of each of the beneficiaries.

On or about the same day the trusts were executed, the trustee leased the real property to Mathews, who continued to operate the premises as a funeral home. The lease was prearranged. On February 1, 1963, the trustee and Mathews signed a new lease for a term of fifty-two weeks at a rent of $14,040, payable at the rate of $270 per week. The rent was calculated to produce a profit for the trusts after expenses. The lease gave Mathews an "option" to renew the lease, " . . . from year to year upon such terms as shall be mutually agreeable to the parties. . . ." This lease, or renewals thereof, was in effect during the years in question. Mathews paid

$14,310, $14,040 and $14,040 as rent for the years 1964, 1965 and 1966, respectively, and these amounts were deducted on Petitioners' joint federal income tax returns for those years. The rent payments were included in the income reported by the four trusts for their fiscal years ending January 31, 1964 through 1967. The rent paid in 1964, 1965 and 1966 was a reasonable rent for the premises.

In order to protect Petitioners from possible adverse tax consequences, and because they became willing and able to relinquish their reversionary interests in the trusts, Petitioners executed a subsequent trust agreement on May 23, 1966, and transferred, by duly recorded quitclaim deed, their reversionary interests in the funeral home property to the new irrevocable trust for the benefit of their four children.

Respondent, in a statutory notice of deficiency dated June 5, 1969, disallowed the rent deductions for the calendar years 1964 and 1965 and for the period from January 1 to May 23, 1966, to the extent of $4,740.65, $5,166.43 and $2,042.22, respectively. These amounts were arrived at by deducting from the gross rent paid to the four trusts the taxes, depreciation, interest and other expenses associated with the funeral home property. Respondent allowed the deduction of rental payments to the trusts from and after the Petitioners' transfer of their reversionary interests to the irrevocable trust on May 23, 1966. Petitioners timely filed a petition in the Tax Court contesting the deficiencies on September 2, 1969.

The Tax Court, in an opinion reviewed by the Court, with one dissent, held that the rental payments to the four trusts were ordinary and necessary expenses deductible under Section 162(a)(3) of the Internal Revenue Code of 1954. Respondent appealed, and the Court of Appeals reversed the decision of the Tax Court and ordered judgment to be entered for Respondent. Petitioners' motion for rehearing was denied.

## REASONS FOR ALLOWANCE OF THE WRIT

It is important that the decision of the Court of Appeals below be reviewed by this Court and reversed, for the following reasons:

1. OF THE FIVE COURTS OF APPEALS WHICH HAVE DECIDED THIS ISSUE, ONLY TWO OF THE DECISIONS CAN BE RECONCILED WITH EACH OTHER. AS A RESULT, THE LAW ON THIS IMPORTANT ISSUE IS IN A STATE OF CONFUSION, AND CAN ONLY BE CLARIFIED BY A DECISION OF THIS COURT.

Five United States Courts of Appeals have decided cases involving the deductibility of rent paid by a father who transferred his business property to a trustee for the benefit of his children (or in one case, directly to the children) and simultaneously leased the property for his own business use. Of these five Courts of Appeals, only two, the Seventh Circuit, in *Skemp v. Commissioner*, 168 F.2d 598 (7th Cir. 1948) and the Third Circuit, in *Brown v. Commissioner*, 180 F.2d 296 (3d Cir. 1950), *cert. denied* 340 U.S. 814 (1950), applied the same test of deductibility. In *Skemp*, the court held that even though the transfer to the trustee was voluntary, once the transfer was made divesting the grantor of title, and the property was leased back under a valid lease, the rent was unquestionably *required* to be paid within the meaning of Section 23 of the Internal Revenue Code of 1939 (the predecessor of Section 162 of the 1954 Code) and therefore deductible. In *Brown*, the Third Circuit agreed with *Skemp*, stating that the fact that the lease was entered into pursuant to a prior understanding between the grantor and trustee was not significant. The controlling point was that an independent trustee became owner of the property and *required* payment of rents as a condition to the continued use of the property by the grantors.

The Fifth Circuit, in *Van Zandt v. Commissioner*, 341 F.2d 440 (5th Cir. 1965), *cert. denied* 382 U.S. 814 (1965),

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held that the rent was not deductible, distinguishing the *Skemp* case because it involved an independent trustee (Van Zandt was the grantor and the trustee). The *Van Zandt* case also stated that there was no business purpose for the transfer. *Van Zandt* was indirectly overruled by the opinion below in the instant case, however, where the Fifth Circuit held that neither an independent trustee nor business purpose for the transfer were of any significance.

In a case involving a direct transfer of property to minors and the appointment of the father-grantor as their guardian, the Ninth Circuit, in *Brooke v. United States*, 468 F.2d 1155 (9th Cir. 1972), held that, since the guardianship met the "independent trustee" requirement and there were "non-tax motives" for the transfer, the transfer had "economic reality" and the rent was deductible.

In *Perry v. United States*, 520 F.2d 235 (4th Cir. 1975) *petition for cert. filed*, 44 U.S.L.W. 3265 (U.S. Nov. 4, 1975) (No. 75-625), the Fourth Circuit followed the "business purpose" test of the Fifth Circuit's *Van Zandt* case (which was rejected three months later by the Fifth Circuit in the instant case). The Fifth Circuit in the instant case, unlike the Ninth Circuit in *Brooke*, spoke of economic reality of the trusts, rather than economic reality of the transfer, as the test. Unlike *Brooke*, which found that "independent trustee" plus "non-tax motives" added up to economic reality, the Fifth Circuit said that neither the independent trustee nor any business purpose had any significance.

Therefore, among the five different U. S. Courts of Appeals which have considered the issue there exist four different tests of deductibility:

1. Transfer to an independent trustee followed by a valid lease which required payment of rent. *Skemp* and *Brown*.

2. Economic reality of the transfer. *Brooke.*

3. Economic reality of the trust. *Mathews.*

4. Business purpose for the transfer. *Perry.*

Obviously, all four of these different tests can not be the law on this issue. That it is an important issue is pointed up by the fact that it is listed by the Internal Revenue Service as a "prime issue." Internal Revenue Manual, MT 1277-8, Nov. 19, 1974. As a prime issue, it will continue to be litigated, with increasing confusion, until it is decided by this Court.

To leave the issue unresolved in the six judicial circuits which have not yet considered it (and indeed in the Fifth Circuit, where *Van Zandt* and *Mathews* are *contra* to each other) will result in considerable needless future litigation involving untold time and expense to the government and taxpayers.

2. THE COURT OF APPEALS WAS MISTAKEN IN THE "CRITICAL" FACTUAL PREMISE UPON WHICH ITS DECISION WAS BASED, I.E., THAT A LEASE EXECUTED CONTEMPORANEOUSLY OR PRIOR TO THE TRANSFER IN TRUST PRACTICALLY ASSURED TAXPAYER'S EFFECTIVE CONTROL OF THE PROPERTY THROUGHOUT THE TERM OF THE TRUST.

The Court of Appeals found that the "critical element" in this case was the trustee's "pre-execution agreement" with the taxpayers, and stated that, "Taxpayer's effective control of the property for the duration of the term was practically assured, notwithstanding the trustee's independence."

It is apparent that the Court did not understand two basic facts about the lease. First, as the Tax Court pointed out in its opinion, the lease in effect during the years in question was *not* the original lease which was pre-arranged at the time of the transfer, but was a second lease, negotiated and

entered into more than a year after the transfer. Secondly, the "option" to renew in the second lease, like the "option" in the first lease, was conditioned upon *mutual agreement* of the parties. Therefore, it was not an enforceable option. *Camichos v. Diana Stores Corp.*, 25 So.2d 864 (Fla. 1946). Indeed, it was the very fact that the trustee kept control of the property by executing a lease for only one year which required mutual agreement for any renewal which the Tax Court pointed to as evidence that the trustee was independent. 61 T.C. at 19. Because the Court of Appeals misunderstood these basic facts, its finding that prior to the transfer the taxpayer assured himself of control of the property for the entire term of the trust, which is the basis of its decision, is in error.

3. THE TEST OF "ECONOMIC REALITY" ADOPTED BY THE COURT OF APPEALS IS INVALID, SINCE IT IS NOT SUSCEPTIBLE TO DEFINITION OR OBJECTIVE APPLICATION. THE PROPER TEST IS THE ONE BASED UPON THE STATUTE, AND APPLIED BY THE SEVENTH AND THIRD CIRCUITS, THAT WHERE THE TAXPAYER TRANSFERS BUSINESS PROPERTY TO AN INDEPENDENT TRUSTEE WHO LEASES IT BACK UNDER A VALID WRITTEN LEASE WHICH REQUIRES THE PAYMENT OF A REASONABLE RENT AS A CONDITION OF CONTINUED OCCUPANCY OF THE PREMISES, THE RENT PAYMENTS ARE DEDUCTIBLE.

Of all the tests adopted by the various Courts of Appeals on this issue, the one adopted below is the hardest to objectively apply. "Economic reality" is a term which encompasses whatever the court wants it to encompass. For example in *Brooke* it was applied to the transfer and encompassed "independent trustee" and "non-tax motives." In *Furman v. Commissioner*, 381 F.2d 22 (5th Cir. 1967), cited by the Fifth Circuit in *Mathews*, it was applied to the trusts and encompassed a number of factors, including, *inter alia*, that:

1. The trustee was taxpayer's wife, who did nothing more than passively acquiesce to his wishes.

2. Under the trust indenture, the property could not be sold without taxpayer's written consent.

3. Taxpayer withdrew the trustee's power to sell the property.

4. The deed and trust were never recorded.

5. Since the rents were insufficient to produce net income, the beneficiaries in reality had no beneficial interest in the income.

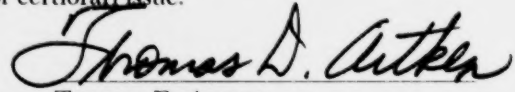
6. Taxpayers applied for a homestead exemption on the trust property in their own names.

In this case, as in *Furman*, the trusts were held null and void for tax purposes, even though no suggestion had ever been made, prior to the Fifth Circuit's opinion, that the trusts were not valid taxable entities. Moreover, while the Fifth Circuit in this case based its decision on the taxpayer's supposed control of the property, the Tax Court specifically held in *Furman* that its decision that there was no economic reality was *not* based upon retention of control by the taxpayer.

In contrast to the decision below, the test as stated in *Skemp* and *Brown* is sensible, workable, predictable and is in accord with the statutory language that the payment of rent be "required." Under the statute the central issue is this: Is the payment of rent *required*? If there is an independent trustee who requires the payment of rent under a valid lease the rent is deductible. The test is simple, direct and legally sound.

## PETITION

In consideration of the foregoing, it is respectfully requested that a writ of certiorari issue.



THOMAS D. AITKEN
of
CARLTON, FIELDS, WARD, EMMANUEL,
SMITH & CUTLER, P.A.
P. O. Box 3239
Tampa, Florida 33601

*Counsel for Petitioner*

BLEED

**C. James MATHEWS et al., Petitioners-Appellees,**

**v.**

**COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellant.**

**No. 74-2084.**

United States Court of Appeals, Fifth Circuit.

Oct. 1, 1975.

Commissioner of Internal Revenue ppealed from decision of the Tax Court, T.C. 12, holding that taxpayers who ransferred ownership of property used husband's wholly owned business to a rust, leasing it back, could deduct rental ayments. The Court of Appeals, rown, Chief Judge, held that where rust was of ten years plus one day du- ation, with corpus reverting to taxpay- rs, and under the trust, income was to e paid to wife as guardian, for benefit f taxpayers' children, the beneficiaries, usband's attorney was named as trus- ee, and trustee's preexecution agree- ient assured taxpayers the property ould be available throughout the term f the trust, the rental payments were ot deductible as ordinary and necessary usiness expenses.

Reversed.

. **Internal Revenue** ⇐570

Fact that taxpayers who transfer wnership of property used in business o a trust and lease it back can conjure p some reason why a businessman ould enter into the transactions, tax consequences aside, does not foreclose inquiry; there must be "economic reality" for the rental payments to be deductible as ordinary and necessary business expenses. 26 U.S.C.A. (I.R.C.1954) §§ 1, 162(a)(3).

2. **Internal Revenue** ⇐236

In deciding federal question of income tax law, court must examine transactions with substance rather than form in mind.

3. **Internal Revenue** ⇐570

Where taxpayers transferred ownership of property used in husband's wholly owned business to a trust which was of ten years plus one day duration, with the corpus reverting to taxpayers at expiration, and under the trust, income was to be paid to wife as guardian, for benefit of taxpayer's children, the beneficiaries, and husband's attorney was named as trustee, in view of trustee's preexecution agreement with taxpayers which for all practical purposes assured that the property would be available throughout the term of the trust, rental payments made to the trust did not qualify as ordinary and necessary business expenses even though lease merely covered one year with a year-to-year option to renew and the rent negotiations produced "reasonable" results. 26 U.S.C.A. (I.R.C.1954) § 162(a)(3).

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Appeal from the decision of the Tax Court of the United States (Florida case).

Before BROWN, Chief Judge, and MURRAH * and WISDOM, Circuit Judges.

* Senior Circuit Judge of the Tenth Circuit, sitting by designation.

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JOHN R. BROWN, Chief Judge:

Because our system of taxing personal income employs a progressive rate,[1] taxpayers may reduce its impact on them if they can split their income amongst family members. The Mathews (Taxpayers) —operators of a funeral home in Florida—attempted this by transferring ownership of the property used in the husband's wholly-owned business to a trust, leasing it back, then deducting the rental payments.[2] They contend the arrangement succeeded in its purpose of crossing to the less burdensome side of the line between *Van Zandt*[3] and *Skemp*.[4] The Tax Court agreed,[5] but we do not. So we disallow the rental deductions.

In cases such as this, the circumstances of the trust settlement are significant—and here, undisputed. The trust was of 10 years plus one day duration, with the corpus reverting to the grantor-settlors at expiration.[6] Under the trust, income was to be paid to Mrs. Mathews, as guardian, for the benefit of taxpayers' children, the beneficiaries. Mr. Mathews' (the settlor) attorney was named as trustee. Pursuant to earlier agreement made contemporaneously or shortly before executing the trust indenture, the trustee leased—with year to year renewal options—the entire corpus to Mathews. The Tax Court found—and we have no reason to discredit it—the attorney, wearing his trustee hat, did everything that reasonably could be expected to protect the children's interest.

[1] In *Van Zandt*, before which Taxpayers flee, the arrangement was very similar. The only real difference—the one urged by Taxpayers—is in the trustee's identity. *Van Zandt* took no chances—or perhaps too many—naming himself trustee. But this was but one of several factors. The outcome would not have differed had there been an outside independent trustee. We think *Van Zandt* teaches that it is not sufficient merely to serve up some "business purpose" as some of the cases put it. The fact taxpayers can conjure up some reason why a businessman would enter into this sort of arrangement—tax consequences aside—does not foreclose inquiry.[7] Rather there must be "economic reality", *Furman v. Commissioner*, 1966,

1. Int.Rev.Code of 1954, § 1.

2. See, *Id.*, 26 U.S.C.A. § 162(a)(3).

3. *Van Zandt v. Commissioner*, 5 Cir., 1965, 341 F.2d 440. This relied heavily on our earlier *W. H. Armston Co. v. CIR*, 5 Cir., 1951, 188 F.2d 531.

4. *Skemp v. Commissioner*, 7 Cir., 1948, 168 F.2d 598. Taxpayer also stresses *Brown v. CIR*, 3 Cir., 1950, 180 F.2d 926, and *Brooke v. United States*, 9 Cir., 1972, 468 F.2d 1155, as well as the gift cases, *Visintainer v. CIR*, 10 Cir., 1951, 187 F.2d 519, and ours in *Henson v. CIR*, 5 Cir., 1949, 174 F.2d 846.

5. See, C. J. Mathews, 61 T.C. 12, Dec. 32, 161.

6. Later, Taxpayers irrevocably conveyed their reversionary interest to their children. The Government does not here challenge the arrangement after that date nor do we pass on it. *Brooke v. United States*, 9 Cir., 1972, 468 F.2d 1155, is different because no reversionary interest remained in that taxpayer—unlike our case. But as to other factors *Brooke* cannot be squared with *Van Zandt* by which we are bound.

7. Taxpayers contend their desire to (i) isolate the property from liability, and (ii) discourage employees from aspiring to partnership constitutes such business purposes. As to (i) it is not impressive since taxpayers' equitable and reversionary interests—as well as rights under the lease—are probably reachable by creditors. For (ii) taxpayers continued in the mortuary business which was presumably producing the profits which employees might envy and covet so the status of some of the operational assets as owned or leased would not discourage such hopes.

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45 T.C. 360, *aff'd per curiam*, 5 Cir., 1967, 381 F.2d 22.[8]

[2] In deciding the federal questions of income tax law, we must examine transactions with substance rather than form in mind. If we stood at the top of the world and looked down on this transaction—ignoring the flyspeck of legal title under state law—we would see the same state of affairs the day after the trust was created that we saw the day before.

[3] We think the critical element of this is the trustee's pre-execution agreement with Taxpayers which for all practical purposes assured them the property constituting the essential plant facility for Taxpayers' otherwise wholly-owned business would be available throughout the term of the trust. Taxpayer would distinguish *Van Zandt* on this point because the initial lease there covered the entire trust term, whereas this one merely covered one year—with a year-to-year option to renew. Practically, however, the distinction is without a difference. Taxpayers' effective control of the property for the duration of the term was practically assured, notwithstanding the trustee's independence. Similarly, the fact rent negotiations produced "reasonable" results is totally irrelevant. Any bargaining is simply not at arm's length, because any rent exceeding expenses stays in the Mathews family.

In short, before the trust's creation Taxpayer operated his business on and with necessary property—all under his complete control. The same was true afterward—except he hoped some of his income had been siphoned off to his children. As in *Van Zandt* what was carefully planned to achieve a total result cannot be split into separate parts.

Deduction of rental payments to such "economic nullities" is not contemplated by § 162(a)(3).

Reversed.

8. See Judge Ely's dissent in Brooke, *supra*, 468 F.2d at 1159.



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APPENDIX B

61 UNITED STATES TAX COURT REPORTS

C. JAMES MATHEWS AND JOYCE C. MATHEWS, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 4401-69. Filed October 3, 1973.

1. Petitioners, husband and wife, created several 10-year trusts for the benefit of their minor children to which they transferred property used in the husband's trade or business, which he in turn leased back from the trusts. *Held*, on the facts, the rentals paid constitute ordinary and necessary business expenses, and petitioners' reversionary interest was not a disqualifying "equity" in the property within the meaning of sec. 162(a) (3) and did not preclude petitioners from deducting the reasonable rent paid to the trusts for the use and possession of the term-of-years held by the trusts.

2. Petitioners failed to substantiate by adequate records or corroborating evidence certain claimed business expenses, business gifts, and club dues.

3. Legal fees incurred in connection with the establishment of an irrevocable trust for the benefit of petitioners' children are nondeductible personal expenses.

4. Petitioners failed to prove that a loan payable to them became worthless in the year in issue.

*Thomas D. Aitken*, for the petitioners.

*Charles L. Dunlap*, for the respondent.

HALL, *Judge:** Respondent determined deficiencies in petitioners' Federal income taxes as follows:

| *Year* | *Deficiency* |
|---|---|
| 1964 | $2,974.54 |
| 1965 | 2,774.21 |
| 1966 | 2,545.07 |
| Total | 8,293.82 |

*Pursuant to a notice of reassignment sent to counsel for the parties, and to which no objections were filed, this case was reassigned by the Chief Judge on Oct. 16, 1972, from Judge Craig S. Atkins to Judge Cynthia Holcomb Hall for disposition.

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C. JAMES MATHEWS

The issues for decision are the following:

(1) During the years 1964, 1965, and 1966, are petitioners entitled to rental deductions with respect to payments made to four family trusts?

(2) During the years 1964, 1965, and 1966, are petitioners entitled to business deductions in an amount in excess of that allowed by respondent with respect to business entertainment expenses, business gifts, and club dues claimed by petitioners?

(3) Are petitioners entitled to a business expense deduction of $750 in 1966 for legal fees paid for the drafting of an irrevocable family trust?

(4) Did Joseph Staley's promissory note, payable to petitioner C. James Mathews, become worthless in 1966?

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

Petitioners are husband and wife, and resided in St. Petersburg, Fla., at the time they filed their petition herein. Their joint Federal income tax returns for the years in issue were filed with the district director in Jacksonville, Fla.

1. *Rental Reduction*

During each of the years involved, C. James Mathews (herein referred to individually as petitioner) was a funeral director operating Mathews Funeral Home in St. Petersburg, Fla. Prior to November 1, 1961, petitioners owned the real property on which the Mathews Funeral Home is located. On or about November 1, 1961, petitioners, as grantors, executed four trust instruments, each creating a separate irrevocable trust for one of their four minor children, and transferred to their attorney Richard F. Logan, as trustee of the trusts, four equal undivided interests in the above-mentioned real property. The property was transferred by warranty deed, dated November 1, 1961, which was duly recorded. Each trust provided that it would terminate 10 years and 1 day after execution of the trusts, whereupon the principal of the trust was to be distributed to the

grantors or their estates. During the term of the trusts the net income was to be distributed currently to the beneficiary, Petitioner's wife was appointed legal guardian of the four minor children who were the beneficiaries of the four trusts.

During the years in issue the trustee, Richard F. Logan, at all times carried on his fiduciary duties independently of petitioners, for the primary benefit of the trust beneficiaries, and in accordance with the broad powers granted him by the terms of the four trusts. In such capacity he managed the property, collected the rents, paid the expenses, negotiated lease renewals as needed, and paid out the income of the trusts as required by the terms of the trust instruments.

On or about November 1, 1961, the day the trusts were executed, the trustee leased the real property to petitioner who continued to operate the premises as a funeral home. This transaction was prearranged. On February 1, 1963, the trustee and petitioner entered into a new lease of the property for a term of 52 weeks at a total rent of $14,040, payable at the rate of $270 per week. This sum was calculated to produce a profit for the trusts after all expenses. Petitioner was given the option to renew the lease "from year to year upon such terms as shall be mutually agreeable to the parties." This lease, or renewals thereof, was in effect during the years in question. Petitioner paid $14,310, $14,040, and $14,040 as rent for the calendar years 1964, 1965, and 1966, respectively, and deducted these amounts on petitioners' joint Federal income tax returns for those years. The payments were included in the income reported by the four trusts for their fiscal years ending January 31, 1964 through 1967. The rent paid during 1964, 1965, and 1966 was a reasonable rent for the premises.

In order to protect petitioners from possible adverse tax consequences, and because petitioners later became willing and able to relinquish their reversionary interest in the trusts, petitioners executed a subsequent trust agreement on May 23, 1966, whereby they transferred their reversionary interests in the funeral home property to a new irrevocable trust for the benefit of their four children. The transfer to the 1966 trust was by quitclaim deed dated May 23, 1966, which was duly recorded on June 1, 1966.

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Respondent disallowed petitioners' rental deductions for the calendar years 1964 and 1965 and the period January 1 to May 23, 1966, to the extent of $4,740.65, $5,166.43, and $2,042,22, respectively. These amounts were arrived at by deducting from the gross rent paid to the four trusts the taxes, depreciation, interest, and other expenses associated with the funeral home property. Respondent allowed the deduction of rental payments to the trust from and after petitioners' transfer of their reversionary interests to the 1966 trust on May 23, 1966.

2. *Entertainment Expenses, Business Gifts, and Club Dues*

Respondent disallowed the following amounts claimed by petitioners as business entertainment expenses and business gifts:

| *Year* | *Amount disallowed* |
|---|---|
| 1964 | $2,468.64 |
| 1965 | 1,745.73 |
| 1966 | 877.43 |
| Total | 5,091.80 |

Disallowance of certain of these expenses has been accepted by petitioners. The expenses still in issue were for alleged business entertainment at the Lakewood Country Club, the St. Petersburg Yacht Club, the Sand Dollar Restaurant, the Port-O-Call Restaurant, the Sheraton Inn, and the petitioners' home, and for certain alleged business gifts given by petitioners.

In addition, respondent disallowed petitioners' claimed deductions for club dues as follows:

| *Year* | *Amount disallowed* |
|---|---|
| 1964 | $ 456.40 |
| 1965 | 505.41 |
| 1966 | 463.50 |
| Total | 1,425.31 |

Disallowance of certain of these club dues has been accepted by petitioners. The club dues still in issue were for dues paid to the Lakewood Country Club and the St. Petersburg Yacht Club.

During the years in issue, petitioner deducted as business expenses portions of his monthly bills from the Lakewood Coun-

try Club. Petitioner was an active member of the Lakewood Country Club, and during 1964, 1965, and 1966 frequently entertained people there by buying them food and drinks, especially after a golf game. Petitioner kept no contemporaneous or substantially contemporaneous records of the persons he entertained at the club. Petitioner believed that if during any such entertaining he made a friend or acquaintance aware of the fact he was a funeral director, the expense of entertaining that friend or acquaintance was a deductible business expense. Petitioner's family also used the Lakewood Country Club, and petitioner's wife, like petitioner, frequently played golf. Petitioners deducted the expenses for the activities they believed were business related and did not deduct the expenses for activities they believed were personal and nonbusiness. Petitioners also deducted a portion of the Lakewood Country Club dues.

Petitioner was also a member of the St. Petersburg Yacht Club and he deducted as business expenses a portion of his yacht club bills during the years in issue. One amount was for drinks purchased for a number of petitioner's friends on the occasion of a benefit dinner for the Science Center. Petitioner regarded these friends as a possible source of business. Another amount was for cocktails for friends prior to the annual Black and White Ball. Petitioner usually took the same group of people to the Ball each year. Another amount was for a cocktail and dinner party in 1966 honoring petitioner's wife's birthday which was attended by about 15 friends. Again petitioner kept no substantially contemporaneous record of his entertaining at the St. Peterburg Yacht Club, but he deducted the amount of his total club bills and club dues he believed to be business related.

During the years in issue petitioner often took salesmen (particularly casket salesmen Joseph Staley and Art Christy) to the Sand Dollar for lunch and deducted the cost thereof as a business expense. Petitioner and his guests ate in the businessmen's luncheon room which petitioner regards as quiet and conducive to carrying on business. The salesmen and petitioner would alternate buying each other lunch. Business was generally discussed in some manner or form during these luncheons. Petitioner kept no substantially contemporaneous records of his luncheon expenses at the Sand Dollar. In addition to lunching with salesmen at the Sand Dollar, petitioner ate lunch with the finance committee of his church, and from time to time enter-

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tained family and friends there. Petitioner deducted the meals he believed to be business related.

During the period in issue petitioners deducted certain expenses at the Port-O-Call, a restaurant and motel complex in St. Petersburg. Petitioner gave various parties there. In 1964 petitioner gave a party in honor of his wife's birthday. On that occasion petitioner asked a number of friends for cocktails in a private room followed by dinner in the main dining room to the music of Guy Lombardo. Preceding the cocktail and dinner party at the Port-O-Call, petitioner held a cocktail party at his home and deducted its cost as a business expense. Again no substantially contemporaneous records were kept by petitioner.

On one occasion in 1966 petitioner had dinner with Mrs. C. C. Alexander and Colonel and Mrs. Charles A. Pheffer at the Sheraton Inn Petitioner had buried Mrs. Alexander's late husband and she now wanted the Pheffers to meet petitioner since they "were getting up in years." Petitioner paid for and deducted the entire cost of the dinner. The Pheffers are still alive.

From time to time petitioners would entertain guests at their own home. One such event was petitioners' annual New Year's Day party. Between 150 and 200 friends and acquaintances annually attended this party. The primary purpose of the party was to watch the New Year's Day football games, and the secondary purpose was to promote goodwill for petitioner's business. Petitioners would rent two or three television sets and operate them simultaneously throughout their home during the party. Petitioners deducted some of the expenses of the 1966 party as business-related expenses.

Petitioner purchased a case of Tanqueray gin in January 1964. He gave away bottles of the gin in order to promote his business. He gave one bottle each to a Mr. Angle and a Mr. Stephenson, both of whom are personal friends. He has no record and cannot remember to whom he gave the other bottles. Petitioners deducted the entire cost of the case of gin as business gifts.

3. *Legal Fees*

In 1966 petitioners paid their attorney $750 for legal services rendered in connection with the establishment of the May

23, 1966, irrevocable trust for the benefit of their children, to which they transferred their reversionary interest in the funeral home property. In his statement, the attorney described the services rendered, without allocation, as "Research for, conferences concerning, and drafting of Irrevocable Family Trust Agreement." Petitioners deducted the $750 as a business expense on their 1966 income tax return. Respondent disallowed the deduction on the grounds the expense was personal in nature.

### 4. *Worthless Note*

On September 16, 1966, petitioner loaned Joseph Staley $2,500, and in exchange received Staley's $2,500 demand note bearing interest at 6 percent per annum. Petitioner did not ask Staley to repay the loan during 1966 because he did not believe Staley could pay it.

During 1966 Staley's assets consisted of his home and stock in a corporation. In 1967 the corporation purchased his stock for a note payable at the rate of $520 a month for 20 years. Staley intended to repay his $2,500 note and had a reasonable prospect of doing so as of the end of 1966.

Petitioners deducted the loan as a nonbusiness bad debt on their 1966 income tax return.

## OPINION

### 1. *Rental Deduction*

Petitioners contend that payments made to the four trusts are ordinary and necessary business expenses in the nature of rent deductible pursuant to section 162(a)(3).[1] However, respondent contends that such payments are not deductible, prin-

[1] All Code references are to the Internal Revenue Code of 1954, as in effect during the years in issue.

Sec. 162(a) (3) provides:

(a) IN GENERAL.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

* * * * * * *

(3) rentals or other payments required to be made as a condtion to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

cipally because petitioners are said to have retained a disqualifying interest in the property. We agree with petitioners.

The question whether a taxpayer, who has transferred to a trust property previously owned by him and used in his trade or business, may lease this property from the trust and deduct his rental payments pursuant to section 162(a)(3) has been considered by the courts on numerous occasions.

Under the cases, it is common ground that rent paid by a grantor to a trustee in such a gift and leaseback is deductible under section 162(a)(3) only if the following requirements are met:

(1) The grantor must not retain "substantially the same control over the property that he had before" he made the gift. *Sidney W. Penn*, 51 T.C. 144, 150 (1968). This requirement is usually met through a transfer to an independent trustee who has the right and the opportunity to negotiate regarding the leaseback and who acts for the primary benefit of the trust beneficiaries, rather than the grantor. *Van Zandt* v. *Commissioner*, 341 F.2d 440 (C.A. 5, 1965), affirming 40 T.C. 824 (1963), certiorari denied 382 U.S. 814 (1965); *Brown* v. *Commissioner*, 180 F.2d 926 (C. A. 3, 1950), reversing 12 T.C. 1095 (1949), certiorari denied 340 U.S. 814 (1950); *Skemp* v. *Commissioner*, 168 F.2d 598 (C.A. 7, 1948), reversing 8 T.C. 415 (1947).

(2) The leaseback should normally be in writing[2] and must require payment of a reasonable rental. *Sidney W. Penn*, *supra* at 152-153.

(3) The leaseback (as distinguished from the gift) must have a bona fide business purpose. *Alden B. Oakes*, 44 T.C. 524 (1965).

We find that these requirements are met.

First, the trustee, we have found as a fact, acted independently of the petitioners- grantors under broad powers specifically set forth in the four trust agreements. See *Brown* v. *Commissioner*, *supra*; *Alden B. Oakes*, *supra*; *Albert T. Felix*, 21 T.C. 794 (1954). As such trustee, he entered into a 1-year written lease of the property which was renewable annually *only* if mutually agreeable terms could be reached by the trustee and

[2] But see *Brooke* v. *United States*, 468 F. 2d 1155 (C.A. 9, 1972).

petitioner. The years here in issue were renewal periods. The trustee collected rents due under the lease, paid the trusts' expenses, negotiated renewals with the grantor as required, and distributed the net income for the benefit of the minor beneficiaries or directly to their legal guardian. In this respect the case must be distinguished from cases such as *Van Zandt* v. *Commissioner*, *supra*, relied on by respondent, in which lack of independence in the trustee was deduced not only from the fact that the grantor named himself as trustee but also from the fact that the lease transaction was prearranged at the inception of the trust, apparently for the entire 10-year term of the trust. In *Van Zandt*, the trustee had little or no room, therefore, for the exercise of independent discretion and had little to do in his fiduciary capacity but collect the prearranged rentals. The grantor thus failed to relinquish effective control over the property and was not permitted to deduct rentals paid therefor.

Secondly, the lease in question was in writing, and we have found as a fact that the rent paid by petitioners to the trusts was a reasonable rent for the property. See *Alden B. Oakes*, *supra*; *Albert T. Felix*, *supra*.

Third, there was demonstrated business purpose for the lease. The rent was clearly both ordinary and necessary and was required to be paid as a condition to continued use of the property. "[W]e think that where, as here, a grantor gives business property to a valid irrevocable trust over which he retains no control and then leases it back, it is not necessary for us to inquire as to whether there was a business reason for making the gift. Admittedly there was none. Under such circumstances the test of business necessity should be made by viewing the situation as it exists after the gift is made." *Alden B. Oakes*, *supra* at 532; *Brooke* v. *United States*, 468 F.2d 1155 (C.A. 9, 1972). Here petitioner needed the building to carry on his funeral business and agreed to rent the property from the trustee for a reasonable rent.

But, respondent argues, all of the above points are immaterial because petitioners had a disqualifying *equity* in the property, in the form of a reversionary interest, and under the plain words of the statute a taxpayer can deduct rent only if paid for "property to which the taxpayer has not taken or is not taking

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title or in which he has no *equity*."[3] (Emphasis added.) The question is whether petitioner's ownership of a reversionary interest constituted an "equity" in the rental "property" within the meaning of section 162(a)(3). The statutory phrase is singularly opaque, and on its face could be susceptible to a number of different meanings. Reading the language at its broadest, the term "property" could mean the fee simple absolute title to the parcel of real estate in question, and the term "equity" could mean any beneficial share (beyond the leasehold interest itself) in the bundle of rights making up such title. If this construction were correct, respondent would prevail, for petitioner concededly held a reversionary interest in the funeral home property, to become possessory upon expiration of the term of years held by the trust. On the other hand, in the context of section 162, it is at least equally permissible to contend that the "property" in which petitioner may not take title or have an equity is, for this purpose, limited to the particular bundle of property rights owned by the lessor at the inception of the lease and forming the subject matter of the lease. Under the latter construction, petitioner would prevail, for the only property owned by the lessor-trusts was the term of years which constituted the trusts corpus, petitioner at no time owned part of the trusts' corpus, and the trusts at no relevant time owned or leased to petitioner any part of petitioner's reversion. In the construction of section 162(a)(3), we are unassisted by any legislative history explaining the phrase,[4] or by any prior holdings of this Court considering it in the present context of a lessee's ownership of a reversionary interest to become possessory at or after the expiration of the lease. In the absence of any guidance from legislative history or well-reasoned earlier case law, we must reach the best answer we can in light of the application of common-sense to the general structure and purpose of the Internal Revenue Code, and specifically, section 162.

[3] The funeral home property appears to have been subject to a mortgage, but the record does not disclose whether the trusts or the grantors were making principal payments (if any) on the mortgage note. Since respondent does not contend that any "equity" was being built up out of rentals through this mechanism, but relies solely on petitioners' retention of the reversion, we need not speculate on what would be the effect on rental deductions under sec. 162(a)(3) of mortgage principal payments by a trust.

[4] The phrase came into the the statute in 1916, sec. 12(a) (1st) of the Revenue Act of 1916, Pub. L. No. 271, 64th Cong., 1st Sess.

Most of the cases dealing with this particular phrase of section 162(a)(3) concern whether a purported lease of property is in actuality a sale, so that the so-called "rental" payment secured for the "lessee" not only the right to use and possession during the lease term, but in addition an ownership interest, or equity, in the "leased" property. Purported rentals which are a disguised purchase price of a "lessor's" property rights must be capitalized rather than deducted. *Benton* v. *Commissioner*, 197 F.2d 745 (C.A. 5, 1952); *M & W Gear Co.*, 54 T.C. 385 (1970), modified by 446 F.2d 841 (C.A. 7, 1971); *Earl L. Lester*, 32 T.C. 711 (1959); *Chicago Stoker Corp.*, 14 T.C. 441 (1950); *Judson Mills*, 11 T.C. 25 (1948). See Rev. Rul. 55-540, 1955-2 C.B. 39; 4A Mertens, Law of Federal Income Taxation, sec. 25.108. Such use of section 162(a)(3) is unexceptionable on any interpretation. The transaction is in fact a purchase, and rather than deducting the payments currently as rentals, the lessee must add them to his basis and may thereafter obtain tax recognition of them in the prescribed manner, normally under either section 167 (by depreciation) or section 1001(a) (in determining the amount of gain or loss on disposition).

It is equally clear that where the purported property of the lessor for tax purposes is treated as owned by the lessee because of an ineffectual gift, as to a nonindependent trustee, the requirements of section 162(a)(3) have not been met. In such case, the lessee has an equity in the property in the form of effective ownership. E.g., *Van Zandt* v. *Commissioner*, *supra*; *Sidney W. Penn*, *supra*.

But respondent would give the phrase in question a much broader meaning. He contends that even if the rental payments in question secured for the lessee nothing more than the use or possession of property during the limited period to which the payments relate, the payments are nevertheless not deductible if the lessee happens to own property rights in the same asset, albeit not derived from the lessor's rights, and not scheduled to become possessory until a later period. Thus, contends respondent, the disqualifying "equity in the property" as used in section 162(a)(3) includes a reversionary interest owned at all times by the lessee and not acquired from the lessor through the lease.

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At the outset, we note that if the term "equity," as respondent appears to contend, is claimed to include any rights in an asset which could be enforced by a court of equity, respondent proves too much. Any lessee has such rights, including a right to specific performance of the terms of the lease. See, e.g., *Crossman v. Fontainebleau Hotel Corp.*, 273 F. 2d 720 (C.A. 5, 1959); *Thurman v. Trin*, 199 Kan. 679, 433 P. 2d 367 (1967); *Pedrick v. Vidal*, 95 Fla. 952, 116 So. 857 (1928). No rentals would ever be deductible under this construction. Thus it is at least clear that "equity" has a narrower meaning. The issue is whether that narrower meaning is still broad enough to cover a lessee's ownership rights in an asset held concurrently with, but not derived from, the lessor's property rights or enlarged through the rental payments. If, for example, a lessee was at all times the owner of a 50-percent undivided interest in a parcel of land, would he be precluded by section 162(a)(3) from deducting the rental paid to his coowner for the use of the latter's rights? In answer to this question, we must of course set aside the particular facts of the present case, with its overtones of careful tax planning, for if the term "equity" has in the present context the broad meaning for which respondent argues, it must have the same meaning where no tax plan is involved.

We gain some help from the language of the statute. The language "property to which the taxpayer *has not taken or is not taking* title" (emphasis added) appears clearly enough to indicate that Congress had in mind an ongoing process in which the taxpayer *takes* (not "has") title to the property, evidently from the lessor through the purported rental payments. It is difficult to read into this language a prohibition on preexisting ownership of property rights in the asset other than those *owned or purportedly owned by the lessor and the subject of the lease*. We note, furthermore, that the disjunctive "or" rather than the conjunctive "and" is used after the phrase "the taxpayer has not taken or is not taking title." Literally, the rent would therefore pass muster if the taxpayer "has not taken or is not taking title" without regard to whether he has an "equity"; and even if title is taken, the rental for the property would still not be rendered nondeductible by the "taking title" language unless the taxpayer has an equity.[5] Whether or not this

[5] Without adverting to the the literally disjunctive phraseology, *Oesterreich v. Commissioner*, 226 F. 2d 798 (C.A. 9, 1955), reads the requirements of the statute in the conjunctive.

reading is warranted, however, the disjunctive at the least seems to render it clearer that Congress intended the "or" clause to be read in conjunction with the preceding language. This would suggest that the kind of "equity" in the "property" referred to must be one "taken" (from the lessor), or at least overlapping a purported ownership interest of the lessor.

The statutory language, however, is so murky that it is too frail a reed to lean on alone. While it appears from the foregoing that Congress probably intended to disqualify an equity *taken* (from the lessor) rather than a preexisting ownership interest not derived from or enlarged under the lease, the language literally refers to the taxpayer *having* rather than *taking* an equity, and the disjunctive "or" may have been an oversight. We rest our conclusion therefore primarily on the fact that respondent's construction would produce such anomalous and unfair tax results in the present context that we cannot hold that Congress could have intended such construction without compelling evidence that this was its intent. Where respondent applies section 162(a)(3) to a purported lease which is really a sale, no injustice is done. The payment in such case enlarges the taxpayer's ownership rights and may in due course be recovered taxwise. But here, the rental payments did not enlarge petitioner's ownership. They were clearly ordinary and necessary business expenses attributable to the years in issue. If they are nondeductible, they may not be capitalized. They purchase nothing of value beyond the years in issue. They will simply be lost. Therefore, the effect of respondent's argument is to require a systematic overstatement of petitioner's net income for each year in which a part of the bona fide and necessary cost of earning that income was the rental payment in question. We are therefore of the view that section 162(a)(3) should not be read to cause rental payments to become nondeductible merely by virtue of a lessee's property rights in an asset, which rights are not derived from the lessor or under the lease, and which will become possessory only after the lease expires.

Under respondent's interpretation, the owner of a reversion to become possessory only after a 99-year lease would apparently be precluded from deducting bona fide rentals paid for a 10-year sublease. Anybody else entering in[illegible]uch a sublease could surely deduct his rental payments, and we see no good reason to attribute to the Congress the desire to distort the measure-

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ment of income by prohibiting such a deduction to the reversioner alone. Likewise, respondent's interpretation would seem to bar the owner of an undivided interest in an asset from leasing the remaining interests from his coowners, and this for no good reason which has been pointed out to us. In order to avoid ascribing to the Congress so capricious a limitation on the rental deduction, we hold that the property in which the taxpayer should have no equity does not include a reversionary interest, not derived from the lease or from the lessor, which is scheduled to become possessory after the expiration of a lessor's term of years.

This approach to section 162(a)(3) is consonant with the holding of *Abramson v. United States*, 133 F. Supp. 677 (S.D. Iowa 1955). In that case, certain rental payments under a lease were applied or credited on the lessee's purchase price of certain items, but other rental payments, not included in the purchase price, and therefore not going to build an "equity," were allowed as deductions. Under the sensible *Abramson* approach, section 162(a)(3) prohibits the current deduction of a capitalizable item; it does not operate so as to prevent a taxpayer from deducting rental payments in circumstances where the payments are *not* appropriate additions to a basis account. In this regard, to the extent they may be inconsistent with the views expressed herein, we disagree with *Gibbons v. United States*, an unreported case (D. N.Mex 1970, 25 A.F.T.R. 2d 70-1332, 70-1 U.S.T.C. par. 9365), and the alternative holding in *Hall v. United States*, 208 F. Supp. 584 (N.D.N.Y. 1962).

In *Alden B. Oakes*, *supra*, this Court did not have to decide whether the mere retention of a reversionary interest in the property constituted a disqualifying equity interest, because the Court there found that the taxpayer "had no 'equity' in the property after [he relinquished his reversionary interest] and during most of the time covered by the years in issue." 44 T.C. at 531.[6]

[6] Moreover, in *Irvine K. Furman*, 45 T.C. 360, 366 (1966), affirmed per curiam 381 F. 2d 22 (C.A. 5, 1967), the Court specifically expressed no opinion on this issue. See also *Sidney W. Penn*, 51 T.C. 144, 154 (1968), where this Court held that under the facts of that case the release of the reversionary interest did not thereafter entitle the taxpayers to deduct their rental payments because taxpayers' "dominion and control over the trust property was not significantly diminished by the conveyance of their reversionary interests."

Finally, respondent contends that under our decision in *Jack E. Golsen*, 54 T.C. 742 (1970), affd. 445 F. 2d 985 (C.A. 10, 1971), we are required by decisions of the Court of Appeals for the Fifth Circuit, to which appeal herein will lie, to disallow the rental deduction here. We disagree with respondent's reading of these cases. In *Chace v. United States*, 303 F. Supp. 513 (M.D. Fla. 1969), affirmed per curiam 422 F. 2d 292 (C.A. 5, 1970), the District Court for the Middle District of Florida held that the grantor-lessee in that case was not entitled to a rental deduction, finding that the facts in *Chace* were almost identical with the facts in *Van Zandt v. Commissioner*, *supra*, and that *Chace* clearly fell within the holding of *Van Zandt*. The Fifth Circuit, in affirming Chace per curiam, cited *Furman v. Commissioner*, 381 F. 2d 22 (C.A. 5, 1967), affirming per curiam 45 T.C. 360 (1966), and *Van Zandt*. The facts in the instant case are clearly distinguishable from the facts in *Chace*, *Furman*, and *Van Zandt*, most notably in our crucial finding that the trustee in the instant case is independent. *Chace* also held, in an alternative holding, that the taxpayer retained a disqualifying equity in the property, apparently relying primarily on the fact that the grantor-lessee had the right under the lease agreement to renew the initial 3-year term of the lease for three additional periods of 3 years at the same rental as the original term, the options to renew exceeding the term of the 10-year trust. This circumstance, of course, left the trustee with no real opportunity to exercise genuine control over the property. This was (we think properly) construed by the court in *Chace* as inconsistent with the genuine relinquishment of control to an independent trustee which has been held to be required for deduction of rentals after a gift and leaseback. Clearly the alternative holding does not stand for the proposition that a reversionary interest, standing by itself, is a disqualifying equity in the property, as the respondent contends in the instant case. Because *Chace*, which was affirmed by the Fifth Circuit, is not in point with respect to the issue we must decide and is distinguishable on its facts, our decision in *Jack E. Golsen*, *supra*, does not require a decision against petitioners on this issue. *Estate of George I. Speer*, 57 T.C. 804, 812 (1972); *Wayman A. Collins*, 56 T.C. 1074, 1078 (1971); *Motel Corp.*, 54 T.C. 1433, 1439 (1970).

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2. *Entertainment Expenses, Business Gifts, and Club Dues*

Petitioners contend they are entitled to deduct the entertainment expenses, costs of business gifts, and club dues in issue as ordinary and necessary business expenses within the meaning of section 162, and, further, that they have met the substantiation and other requirements of section 274. Respondent asserts that petitioners have failed to show that such expenditures meet the requirements of either section 162 or section 274. We hold that regardless of whether petitioners' entertainment expenses, costs of business gifts, or club dues constituted ordinary and necessary business expenses deductible under section 162, petitioners have failed to substantiate those expenses by adequate records or other sufficient evidence, and that therefore these expenses are disallowed pursuant to section 274(d) and the regulations thereunder.

Section 274(d) provides that entertainment expenses and the expense of gifts and club dues are not allowable as deductions "unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement (A) the amount of such expense * * *, (B) the time and place of the * * * entertainment, * * * or use of the [club], or the date and description of the gift, (C) the business purpose of the expense * * *, and (D) the business relationship to the taxpayer of persons entertained, using the [club], or receiving the gift."

The regulations (section 1.274-5(c)) provide that "adequate records" consist of an account book or diary or similar record in which the elements of the expenditures are recorded at or near the time of the expenditure. In this case petitioner admits that he cannot meet the adequate records requirement of the statute and regulations since he maintained no contemporaneous diary of the entertainment expenses or gifts or of the use of the clubs. The question, therefore, is whether he has substantiated the expenses by sufficient evidence corroborating his oral testimony. The regulations (section 1.274-5(c)(3)) require such substantiation by a written statement containing detailed information on each element,[7] and other corroborative evidence

[7] The elements in the case of entertainment expenses are the amount, time, place, business purpose, and business relationship of those entertained; and in the case of a gift the amount, time, description of the gift, business purpose, and business relationship of the recipient.

sufficient to establish such elements. The type of corroborative evidence required is (1) the testimony of the person entertained or the recipient of the gift, or of other witnesses, setting forth detailed evidence of the elements, or (2) documentary evidence proving such elements. However, circumstantial evidence may be used to establish the business purpose or the business relationship.

The Second Circuit has held that the taxpayer's detailed statement need not be in writing, and that the portion of the regulations requiring a written statement is invalid. *LaForge v. Commissioner*, 434 F. 2d 370 (C.A. 2, 1970), reversing on this issue 53 T.C. 41 (1969). In other words, the taxpayer's oral testimony, properly corroborated, is sufficient to establish the section 274 elements of business entertainment expenses or the expense of business gifts. Both the Second Circuit and the Tax Court have strictly interpreted the *LaForge* case in determining what is sufficient corroboration of the taxpayer's oral testimony as to the amount, time, place, and business purpose of the expenditures. *Hughes v. Commissioner*, 451 F. 2d 975 (C.A. 2, 1971), affirming a Memorandum Opinion of this Court; *Norman E. Kennelly*, 56 T.C. 936 (1971), affirmed in open court without opinion 456 F. 2d 1335 (C.A. 2, 1972).

In this case, petitioner went back over his bills, receipts, and canceled checks after the Commissioner commenced his audit of the years in issue and tried to the best of his recollection to separate personal expenses from business expenses. These bills, receipts, and canceled checks have no notations as to the amount of the business expense, the business purpose of the entertainment or gift, or the business relationship of petitioners to the recipients of the entertainment or gifts. Petitioner's memory is vague and unspecific, and his testimony was unconvincing. The *only* elements established by the bills, receipts, and canceled checks are the time, place, and amount of *both* the personal and business expenditures of petitioners at various restaurants and clubs, and not the business portion thereof. Moreover, petitioners have failed to substantiate the business purpose of the various claimed expenditures or the business relationships of the parties by documentary or circumstantial evidence.

The testimony of the Lakewood Country Club golf professional and bartender added nothing except to establish that

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petitioners were at the club often. The witnesses were not in a position to nor did they establish the business purpose or business relationships of any of the entertaining petitioners did at the club.

We find that there has not been sufficient corroboration of taxpayer's oral testimony to meet the requirements of section 274(d) with regard to the business entertainment expenses or cost of the business gifts in issue in this case.

In order to be able to deduct any part of the club dues paid to the Lakewood Country Club and the St. Petersburg Yacht Club, petitioners must establish that the clubs were used "primarily for the furtherance of the taxpayer's trade or business." Sec. 274(a)(1)(B) and (2)(A). Petitioners are required to maintain records of the use of a club to establish that its primary use was business related rather than personal. "If a taxpayer fails to maintain adequate records concerning a [club] which is likely to serve the personal purposes of the taxpayer, it shall be presumed that the use of such [club] was primarily personal." Sec. 1.274-5(c)(6)(iii), Income Tax Regs.

Petitioners have failed to carry their burden of proof that the clubs were used primarily for business purposes, and therefore no part of the dues for either club is deductible.

### 3. *Legal Fees*

Petitioners contend the $750 in legal fees paid in connection with establishing the 1966 irrevocable family trust is a deductible business expense. Respondent contends it was a nondeductible personal expense, and we agree.

We hold that the primary purpose in establishing the 1966 trust was to make a gift in trust of the petitioners' reversionary interest in the funeral home property to their children. As such, the legal fees paid petitioners' lawyer to establish the trust were a nondeductible personal expense.

### 4. *Worthless Note*

Petitioner contends that his loan to Staley, evidenced by a demand note, became worthless in 1966. Respondent asserts

that petitioners have failed to prove that the loan became worthless in 1966, and we agree.

Petitioner claimed the $2,500 note became worthless within 3½ months after it was created, but petitioner, on whom the burden of proof rests, has failed to prove that the debt both (1) was not worthless when created on September 16, 1966 (*Russell Box Co. v. Commissioner*, 208 F. 2d 452, 455—456 (C.A. 1, 1953), affirming a Memorandum Opinion of this Court), and (2) became worthless before the end of 1966 (section 166(d)(1)(B)). Petitioner has failed to carry his burden of proof with respect to this issue.

Reviewed by the Court.

*Decision will be entered under Rule 50.*

QUEALY, *J.*, dissenting: In this case, the petitioner admittedly had an equity in the property which he was renting. He owned the property in fee and had merely granted to the trust a term of years, giving the trust no greater interest than that of a lessee. Section 162(a) specifically limits the deduction for rentals to property "in which he [petitioner] has no equity." Regardless of what may have been the intention of the Congress, and I find it difficult to believe that there was any intent to legitimatize this form of transaction, I find no justification for disregarding the clear language of the statute. Accordingly, I believe that the position of the respondent on this issue should be sustained.

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APPENDIX C

# United States Court of Appeals

FOR THE FIFTH CIRCUIT

October Term, 1974

No. 74-2084

Tax Court No. 4401-69

C. JAMES MATHEWS, ET AL.,

*Petitioners-Appellees,*

*versus*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent-Appellant.*

## APPEAL FROM THE DECISION OF THE TAX COURT OF THE UNITED STATES (FLORIDA CASE)

Before BROWN, Chief Judge, and MURRAH* and WISDOM, Circuit Judges.

## JUDGMENT

This case came on to be heard on the transcript of the record of the Tax Court of the United States, and was argued by counsel;

* Senior Circuit Judge of the Tenth Circuit, sitting by designation.

ON CONSIDERATION WHEREOF, It is now ordered and adjudged by this Court that the decision of the said Tax Court in this cause be, and the same is hereby, reversed;

It is further ordered that petitioners-appellees pay to respondent-appellant, the costs on appeal to be taxed by the Clerk of this Court.

October 1, 1975

Issue as Mandate:

APPENDIX D

# United States Court of Appeals

FIFTH CIRCUIT

OFFICE OF THE CLERK
EDWARD W. WADSWORTH
Clerk

600 Camp Street
New Orleans, La. 70130
Telephone 504-539-6514

November 21, 1975

TO ALL COUNSEL OF RECORD

No. 74-2084—C. James Mathews, et al., vs.
Commissioner of Internal Revenue

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Dear Counsel:

This is to advise that an order has this day been entered denying the petition( ) for rehearing, and no member of the panel nor Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc (Rule 35, Federal Rules of Appellate Procedure; Local Fifth Circuit Rule 12) the petition( ) for rehearing en banc has also been denied.*

See Rule 41, Federal Rules of Appellate Procedure for issuance and stay of the mandate.

Very truly yours,
EDWARD W. WADSWORTH, Clerk

by /s/ Susan M. Gravois,
Deputy Clerk

cc: Mr. Richard M. Roberts
Mr. Thomas D. Aitken

* Judge Murrah died on October 30, 1975 and did not participate in the decision on rehearing.

BLEED THROUGH

# In the Supreme Court of the United States

OCTOBER TERM, 1975

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No. 75-970

C. JAMES MATHEWS AND JOYCE C. MATHEWS, PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT*

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## MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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The sole issue presented by the petition in this income tax case is whether purported rental payments, made by petitioner[1] pursuant to a gift and leaseback arrangement, were deductible as ordinary and necessary business expenses under Section 162(a)(3) of the Internal Revenue Code of 1954 (26 U.S.C.).

The relevant facts are as follows: Petitioner owns and operates a funeral home in St. Petersburg, Florida. Prior to November 1, 1961, petitioner owned the realty, comprising the funeral home building and the lot upon which it was located. On November 1, 1961, petitioner transferred the realty (in four equal undivided shares) to irrevocable trusts created on that date for the benefit of his four

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[1]"Petitioner" refers to C. James Mathews. Joyce C. Mathews is a party solely because she filed a joint return with her husband for the years at issue.

minor children. Petitioner's attorney was named trustee for each of the trusts. Each trust provided that it was to terminate ten years and one day after its creation, after which the corpus was to revert to petitioner[2] (Pet. App. B A-6 to A-7).

Prior to the transfer of the property to the trusts, a leaseback arrangement was agreed upon with the prospective trustee pursuant to which the realty was leased back to petitioner, who continued to operate his funeral home business thereon without interruption. On February 1, 1963, petitioner and the trustee entered into a new lease of the property which provided for an initial term of one year with the option given to petitioner to renew the lease from year to year for the duration of the trusts upon mutually agreeable terms. This lease, or renewals thereof, was in effect during the taxable periods (Pet. App. B A-7).

In accordance with the terms of the lease, petitioner paid approximately $14,000 as purported rental payments to the trusts during each of the years 1964, 1965, and 1966. These amounts were deducted by petitioner on his returns for those years as business expenses under Section 162(a)(3) of the Code (Pet. App. B A-7).

On audit, the Commissioner of Internal Revenue disallowed petitioner's claimed rental deductions. The Tax Court upheld the deductibility of the purported rental payments to the trusts (Pet. App. B A-11 to A-19). The court of appeals reversed. It held that the gift and leaseback transaction as a whole had no purpose other than to divert

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[2]Subsequently, on May 23, 1966, petitioner, in an attempt to avoid possible adverse tax consequences, transferred his reversionary interests in the trusts to a new irrevocable trust for the benefit of the children (Pet. App. B A-7).

petitioner's income to his children, and, therefore, the payments made in connection with the transaction were not allowable deductions under Section 162 (a)(3) (Pet. App. A A-1 to A-3).

In so holding, the court of appeals relied on its well-reasoned decision in *Van Zandt* v. *Commissioner*, 341 F.2d 440, certiorari denied, 392 U.S. 814, which was recently followed in *Perry* v. *United States*, 520 F.2d 235 (C.A. 4), certiorari denied, No. 75-625, January 12, 1976. The court rejected petitioner's contention that its earlier decision in *Van Zandt* was distinguishable because the initial lease there covered the entire term of the trust, whereas the initial lease in this case had a one-year term and the subsequent lease had a year-to-year option to renew. It pointed out (Pet. App. A A-3) that, as a practical matter, the distinction was without a difference. It further noted that petitioner's effective control of the property for the duration of the trusts was never in doubt, since the trustee had a clear understanding with petitioner prior to the transfer of the property to the trusts that the property was to be leased back to petitioner so as to permit the continued and uninterrupted operation of petitioner's funeral home business (Pet. App. B A-7; R. 44).[3]

The decision in *Skemp* v. *Commissioner*, 168 F.2d 598 (C.A. 7), relied upon by petitioner (Pet. 5), is not to the contrary. As the Fourth Circuit in *Perry* and the Fifth Circuit in *Van Zandt* (341 F.2d at 442) both noted, *Skemp* was a case in which more property was conveyed to the trustee than was leased back to the grantor-taxpayer for his use. Under these circumstances, there may have been a proper business purpose for the gift and leaseback transaction and

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[3]"R." refers to the record appendix filed in the court of appeals.

hence the trust apparently was not solely a device for the diversion of the taxpayer's earnings to his wife and children. Furthermore, in *Skemp* the grantor retained no reversionary interest in the trust property.[4]

Contrary to petitioner's assertion (Pet. 5-6), the decision below does not conflict with *Brooke* v. *United States*, 468 F.2d 1155 (C.A. 9), or *Brown* v. *Commissioner*, 180 F.2d 926 (C.A. 3), certiorari denied, 340 U.S. 814. Unlike this case, *Brooke* involved an absolute outright conveyance to the taxpayer's children, and not a trust for a term of years. *Brown* involved the transfer by the taxpayer of coal-producing property and a railroad siding to a trust for the taxpayer's children for 22 years. While petitioner's arrangement with the trustee in this case insured that he would retain effective control over the transferred property during the terms of the trusts, the taxpayer in *Brown* leased back the coal property and the railroad siding for only five and ten years respectively. Moreover, unlike petitioner, the taxpayer in *Brown* retained no reversionary interest in the trust property.

In light of these factual differences, the treatment of the trust and leaseback as separate transactions in *Brown* does not conflict with the decision below. As the Fifth Circuit observed in *Van Zandt* (341 F.2d at 444): "* * * factors such as the short term of the trust, reversion to the settlors, predetermination of the right to possession of the property, and the like * * * bear heavily on the element of business purpose."

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[4]Here, the Commissioner disallowed petitioner's claimed rental deductions only with respect to the period during which he retained reversionary interests in the trusts. The deductions were not challenged following petitioner's conveyance of those interests on May 23, 1966 (Pet. App. B A-8).

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
*Solicitor General.*

FEBRUARY 1976.